Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-51-99
[redacted]

date: APR 20 1999

to: Chief, Examination Division, [redacted] District
Attention: [redacted] CEP Team Coordinator
Examination Group [redacted]

from: [redacted] District Counsel, [redacted]
[redacted], Assistant District Counsel
[redacted], Attorney

---

subject: Advisory Opinion re LIFO Inventory Issues [redacted]
Taxpayer: [redacted]
Taxable Years Ended September 30, [redacted], September 30, [redacted] and September 30, [redacted]
Our File No. TL-N-51-99

THIS ADVICE CONSTITUTES RETURN INFORMATION SUBJECT TO I.R.C. SECTION 6103. THIS ADVICE CONTAINS CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES AND (IF PREPARED IN ANTICIPATION OF LITIGATION) SUBJECT TO THE ATTORNEY WORK PRODUCT PRIVILEGE. ACCORDINGLY, THE EXAMINATION OR APPEALS RECIPIENT(S) OF THIS DOCUMENT MAY PROVIDE IT ONLY TO THOSE PERSONS WHOSE OFFICIAL TAX ADMINISTRATION DUTIES WITH RESPECT TO THIS CASE REQUIRE SUCH DISCLOSURE. IN NO EVENT MAY THIS DOCUMENT BE PROVIDED TO EXAMINATION, APPEALS, OR OTHER PERSONS BEYOND THOSE SPECIFICALLY INDICATED IN THIS STATEMENT. THIS ADVICE MAY NOT BE DISCLOSED TO TAXPAYERS OR THEIR REPRESENTATIVES.

THIS ADVICE IS NOT BINDING ON EXAMINATION OR APPEALS AND IS NOT A FINAL CASE DETERMINATION. SUCH ADVICE IS ADVISORY AND DOES NOT RESOLVE SERVICE POSITION ON AN ISSUE OR PROVIDE THE BASIS FOR CLOSING A CASE. THE DETERMINATION OF THE SERVICE IN THIS CASE IS TO BE MADE THROUGH THE EXERCISE OF THE INDEPENDENT JUDGMENT OF THE OFFICE WITH JURISDICTION OVER THE CASE.

At your request, we have reviewed a notice of proposed adjustment (designated as number 19) and the related explanation of items, which we understand were previously given to the taxpayer in this case. You have previously received written advice on these issues. After review of the previous memorandum by the National Office, we are reissuing the memorandum with

appropriate changes. The changes have been highlighted. The notice proposes adjustments to taxable income for the taxable years ended September 30, , September 30, and September 30, , based on three separate and analytically distinct changes to the taxpayer's LIFO inventory computations (which, in turn, result in changes to the taxpayer's cost of goods sold). The three questions presented are as follows:

(1) Should the taxpayer have established a separate LIFO inventory pool for , (as the Service contends), or is it appropriate for the to be included in the existing LIFO inventory pool for ?

(2) Should certain described as "credit/rebill units," be excluded from the taxpayer's ending inventory?

(3) Has the taxpayer properly identified certain items within the inventory pool as Class A, Class B, and Class C items, as those terms are defined in a closing agreement which governs certain aspects of the taxpayer's LIFO inventory accounting for the taxable years at issue?

For the reasons set forth below, with respect to issue 1 it is our opinion that the taxpayer is permitted to include in its existing LIFO inventory pool of . We are unable to render definitive opinions with respect to issues 2 and 3 at this time, because the facts necessary to allow us to do so have not been made available to us. However, in order to assist you in reviewing your records and assembling the necessary facts, we have included a discussion of the applicable legal principles and recommended specific information which should be obtained.

FACTS

We understand the relevant facts to be as follows.[1]

[1] Our understanding of the facts of this case is limited to the facts set forth in your explanation of items. We have not undertaken any independent investigation of the facts of this case. If the actual facts were to be different from the facts known to us, our legal analysis and our conclusions and recommendations might be different. Accordingly, if you learn that the facts known to us are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

General

The taxpayer, is a California corporation with its principal office in California. During the taxable years at issue, was the common parent of an affiliated group of corporations which filed consolidated United States Federal income tax returns. At all times relevant to this case, was a wholly-owned subsidiary of , a corporation ( ).

During the taxable years at issue, principal business activity was the distribution and sale in the United States of It purchased trucks from three sources: , , and , is a corporation with its principal place of business in , and is a wholly-owned subsidiary of , is corporation with its principal place of business in owns percent of the outstanding shares of stock of ; the remaining percent is owned by .

During the taxable years at issue, kept its books and records, and prepared its Federal income tax returns, using the accrual method of accounting. During the taxable years at issue, computed its cost of goods sold for tax purposes using the dollar-value LIFO method of inventory accounting,[2] and determined the current and base-year cost of the items in its closing inventory using the link-chain method.

' inventory accounting practices were the subject of considerable controversy between and the Service in the examinations of prior taxable years. In a closing agreement dated , and the Service agreed, among other things, that inventory of finished for the taxable years ended September 30, through September 30, would be accounted for using two LIFO inventory pools, one for and one for . The closing agreement goes on to state, "The Commissioner may determine the appropriateness of the number and composition of the pools used by Taxpayer with respect to the introduction of new (items) consistent with the principles of Treas. Reg. §1.472-8(c)."[3]

---

[2] adopted the dollar-value LIFO method beginning in its taxable year ended September 30, .

[3] A copy of the closing agreement is attached to this memorandum and marked as Exhibit A.

Issue 1

entered the distribution business in the United States in the late s. For most of its history, its sales were primarily of and . Until relatively recently, the manufactured by were not particularly successful in the United States market.

In the 's decided to enter the segment of the United States market, with a mixture of newly designed models and adaptations of models which were already sold in . 's objective was to produce which achieved greater levels of performance and reliability than comparably priced and models, and which could be priced lower than competitive , and models.

Because of the "down-market" image of the brand in the United States market, decided to create a separate brand for its , The brand name was chosen. In order to enhance the differentiation between and in the United States market, and took a number of steps to separate the and operations. For example, it was decided that although the owners of existing could acquire , and would not be permitted to be sold at a single location, and franchisees were apparently encouraged to adopt names for their dealerships that obscured any relationship with nearby dealerships.[4] Similarly, has engaged separate advertising agencies to prepare advertisements for and , and the campaigns have generally ignored or obscured the relationship between and .

The first were sold in the United States market during taxable year ended September 30, . The brand achieved widespread acceptance almost immediately. In part, early success in the United States market was due to price advantages which , relative to the United States dollar and the ; however, despite aggressive competitive responses and unfavorable currency movements, has maintained a strong position in the segment of the United States market.

During the taxable years at issue, computed its income using the two-pool approach set forth in the closing agreement, including the and in the same pool. You have proposed that the be segregated into a third pool.

---

[4] An example of this phenomenon can be seen at the in central County. The owners of also own the located . However, the is known as " " and its membership in the group of is not publicized.

Issue 2

In your explanation of items, you described the so-called "credit/rebill" [redacted] as [redacted] that were previously sold by [redacted] to one of its regional distributors, but which have been returned to [redacted] (either by physically returning them to [redacted] or by adjusting entries on the books of [redacted] and the distributor) for resale. In its response to your notice of proposed adjustment, [redacted] describes credit/rebill [redacted] as "re-priced, being transferred, slightly damaged, repaired and resold, or invoice errors." Nothing in the materials which have been provided to us provides any indication of whether the cost or the fair market value of credit/rebill [redacted] differs from the cost or fair market value of [redacted] which are not credit/rebill [redacted].

In your explanation of items, you state that prior to the taxable year ended September 30, [redacted] did not include credit/rebill [redacted] in its dollar-value LIFO pools, but instead accounted for them separately using the specific-goods LIFO method. Nothing in the materials which have been provided to us provides any indication of whether [redacted] sought or obtained the permission of the Service to change its method of accounting for the cost of credit/rebill [redacted].

In your explanation of items, you state that in the recomputation of [redacted] LIFO reserve for the taxable years covered by the closing agreement, credit/rebill [redacted] were excluded from the dollar-value LIFO pools. However, the closing agreement does not explicitly address this point, and none of the other materials which have been provided to us provide any indication as to whether you have accurately described the closing agreement.

Issue 3

One of the several issues which were disputed between the Service and [redacted] in the past, and which was intended to be resolved by the closing agreement, was the proper identification of separate items of inventory. The closing agreement provides that for the taxable years at issue in this case, each of [redacted] United States [redacted]" is to be treated as a separate item. The closing agreement also specifically identifies [redacted] which are to be treated as new items in the taxable years at issue in this case.

The closing agreement divides the items in [redacted] LIFO inventory pools into three categories for purposes of computing the indexes used in applying the link-chain method and for purposes of determining base-year costs: Class A, Class B, and Class C. The basis for assigning an item to a class is when the item first becomes part of [redacted] LIFO inventory. Items which first become part of [redacted] LIFO inventory in any given taxable year are always in Class C in that year. If an item first becomes part of [redacted] LIFO inventory during the last nine months of the taxable year, it moves into Class B in the next taxable year, and into Class A in the second succeeding taxable year. If an item first becomes part of [redacted] LIFO inventory during the first

three months of the taxable year, it never moves into Class B; instead, it moves directly into Class A in the next taxable year.

In your explanation of items, you state that:

(1) certain items which were classified as Class C in the taxable year ended September 30, [redacted] were erroneously left in Class C for the taxable year ended September 30, [redacted];

(2) other items which were classified as Class C in the taxable year ended September 30, [redacted] were erroneously moved to Class A for the taxable year ended September 30, [redacted] when they should have moved to Class B;

(3) certain items which were classified as Class A in the taxable year ended September 30, [redacted] were erroneously placed in Class B for the taxable year ended September 30, [redacted];

(4) one item which was classified as Class C in the taxable year ended September 30, [redacted] was erroneously left in Class C for the taxable year ended September 30, [redacted]; and

(5) one item which was classified in Class C in the taxable year ended September 30, [redacted] was erroneously moved to Class A for the taxable year ended September 30, [redacted] when it should have been moved to Class B.

None of the materials which were have been provided to us provide any information regarding the exact dates on which any of the disputed items first entered [redacted]s LIFO inventory.

LEGAL ANALYSIS

General

I.R.C. Section 471(a) provides in general that if the use of inventories is necessary to clearly determine a taxpayer's income, "inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income." I.R.C. Section 472(a) permits a taxpayer which is required to keep inventories to elect to use LIFO, "... in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income." The term "best accounting practice in the industry" is generally interpreted as being synonymous with generally accepted accounting principles. *Wal-Mart Stores,*

Inc. v. Commissioner, 153 F.3d 650, 656 (8th Cir. 1998) (citing *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979)). A method of inventory accounting will be found to clearly reflect income if it complies with GAAP, is consistently used, and produces accurate results. *Wal-Mart*, 153 F.3d at 657 (citing Treas. Reg. § 1.446-1(a)(2)).

Initially, the Service contested taxpayers' attempts to use dollar-value LIFO, taking the position that only specific-goods LIFO was permitted under the Code. However, after a series of adverse decisions by the Tax Court, *see, e.g., Hutzler Brothers Co. v. Commissioner*, 8 T.C. 14 (1947), the Service promulgated regulations governing the use of dollar-value LIFO. *See* Treas. Reg. § 1.472-8.

Issue 1

The proper identification of "items" of inventory, and the proper accumulation of items into LIFO "pools," are crucial to the proper use of dollar-value LIFO. Regulations Section 1.472-8(c) provides that

> Items of inventory in the hands of wholesalers, retailers, jobbers, and distributors shall be placed into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the particular trade in which the business is engaged is an important consideration.

In determining whether separate LIFO inventory pools should be maintained, the courts have generally looked to whether the taxpayer is engaged in more than one trade or business, and required a separate inventory pool for each business. *See, e.g., UFE, Inc. v. Commissioner*, 92 T.C. 1314, 1321-22 (1989); *Amity Leather Products, Inc. v. Commissioner*, 82 T.C. 726 (1984).

Although the matter is not free from doubt, in our view the distribution of [redacted] is a single trade or business, so that the use of a single LIFO inventory pool for [redacted] and [redacted] is permissible.

In a number of cases and rulings involving retail automobile dealers, the courts and the Service have permitted the two-pool approach used by the taxpayer. *Richardson Investments, Inc. v. Commissioner*, 76 T.C. 736 (1981); *Fox Chevrolet, Inc. v. Commissioner*, 76 T.C. 708 (1981); Rev. Proc. 97-36, 1997-33 I.R.B. 14. In Rev. Proc. 97-36, the Service expressly stated that under the alternative dollar-value LIFO method for dealers described therein, all automobiles, regardless of manufacturer, should be placed in a single pool. If that treatment is appropriate, then *a fortiori* it would seem appropriate to place two different model lines manufactured by the same manufacturer in a single pool. Thus, it appears that the taxpayer's two-pool approach is customary in the automobile industry–a consideration which is of great importance under the

Regulations.[5] We are unable to perceive any principled reason why a wholesale distributor should be treated differently than a retail dealer

We acknowledge that if the nature of the business changes over time, a different conclusion might be appropriate for subsequent taxable years. In particular, we note that all of the current [redacted] models are manufactured by [redacted] in [redacted], while an increasing percentage of the [redacted] models sold by [redacted] in the United States are manufactured by [redacted] and [redacted] in the United States. If this trend continues, it may be appropriate at some future time to require separate pooling of [redacted] and [redacted]. *See Amity Leather, supra* (taxpayer required to maintain separate pools for goods it manufactured in the United States and goods it purchased from a wholly-owned subsidiary in Puerto Rico). However, for the taxable years at issue, a single pool for [redacted] and [redacted] is not inappropriate..[6]

Issue 2

Regulations Section 1.472-8(g)(1) provides in relevant part as follows:

---

[5] As you know, two other similarly situated distributors, [redacted], have adopted the same two-pool approach as the taxpayer. In a 1996 field service advice memorandum issued to this office in connection with an examination of another taxpayer, the office of the Assistant Chief Counsel (Domestic Field Service) found the two-pool approach to be permissible.

[6] *But see* 1 L. Schneider, Federal Income Taxation of Inventories, §13.01[2], at p. 13-8:

> In view of the history and the underlying policy of the pooling concept in the dollar-value method, it would appear that the key factor in determining the scope of a particular pool should be "substitutability of goods." Conceptually, a taxpayer should pool goods together on the basis of consumer preferences and the acceptability of substitute products.

We acknowledge that an argument for a separate pool for [redacted] could be made based on Mr. Schneider's "substitutability" theory. It could be argued with some force that a $[redacted] is not an acceptable substitute for a $[redacted] and vice versa). However, on balance we do not find this argument compelling. There has always been, and continues to be, significant overlap between the [redacted] and [redacted] product lines. For example, the current [redacted] s based on and closely resembles the [redacted], and the [redacted] and [redacted] are virtually identical except for [redacted] In addition, recent press reports indicate that the soon to be introduced [redacted] will be priced substantially below the price of fully equipped [redacted] and [redacted]

> *(1) Change in method of pooling.* Any method of pooling authorized by this section and used by the taxpayer in computing his LIFO inventories under the dollar-value method shall be treated as a method of accounting. Any method of pooling which is authorized by this section shall be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in paragraph (e) of § 1.446-1.

Thus, assuming that [redacted] elected to separately account for credit/rebill [redacted] using the specific-goods LIFO method at the time it elected to use dollar-value LIFO as its standard method of inventory accounting, it must continue that treatment unless it obtains the permission of the Service to change by filing a Form 3115.[7]

Issue 3

Regulations Section 1.472-8(e)(1) provides that ordinarily, taxpayers using dollar-value LIFO must use the double-extension method to determine the base year cost and current year cost of a dollar-value LIFO pool. However, where a taxpayer can show that use of the double-extension method is impractical because of the number of items in a pool or rapid changes in the items in a pool, the use of an index or link-chain method is permitted. The use of a link-chain method is customary in the automobile distribution industry. *See, e.g.*, Rev. Proc. 92-79, 1992-2 C.B. 457 (requiring dealers electing the alternative LIFO method to use the link-chain method).

The regulations do not prescribe any particular link-chain method which must be used. The link-chain method is generally similar to the double-extension method, except that instead of using the year in which the taxpayer adopted LIFO as the base year for purposes of computing base-year cost, each year's current costs are restated in terms of the immediately preceding year's costs, and those costs are indexed back to the base year using a cumulative index. *See* 1 Schneider, § 14.02[3], at 14-99.

---

[7] In this connection, we note that if credit/rebill [redacted] are meaningfully different from the rest of [redacted] inventory, or are not held for sale to customers in the ordinary course of [redacted] business, there is support in the case law for not allowing them to be included in [redacted] dollar-value LIFO pools. In *B.A. Ballou & Co. v. United States*, 7 Cl.Ct. 658, 85-1 U.S. Tax Cas. [CCH] ¶ 9290 (Cl.Ct. 1985), the taxpayer was a jewelry manufacturer which accounted for the gold it purchased for use in manufacturing using dollar-value LIFO. During the taxable years at issue, the taxpayer also engaged in speculative purchases and sales of gold. The court held that the gold purchased for speculation could not be included in the taxpayer's dollar-value LIFO pool, because it had not been purchased for sale in the ordinary course of business or for incorporation into a product to be sold in the ordinary course of business.

As described above, the closing agreement groups all of the items in [redacted] LIFO inventory pools into three classes for purposes of computing indexes and base year costs, rather than computing indexes and base year costs separately for each item. Treas. Reg. § 1.472-8(e)(2) provides that the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year. Clearly, [redacted]'s method fails to meet the requirements of the regulations. Unfortunately, both [redacted] and the Service are bound to follow the closing agreement for the years to which it applies. *See, e.g., Estate of Johnson v. Commissioner*, 88 T.C. 225, 231 (1987), *aff'd. unpub. op.*, 838 F.2d 1202 (2d Cir. 1987) ("A closing agreement, once approved by the Secretary, is a final and conclusive agreement between the parties as to all matters contained therein."). We strongly recommend, however. that this particular closing agreement not be used as a model for future closing agreements.

With respect to category (1) described above, we agree that items which were classified as Class C in the taxable year ended September 30, [redacted], cannot properly be included in Class C for the taxable year ended September 30, [redacted]. However, in the absence of any information as to when those items first appeared in [redacted] LIFO inventory, we cannot determine whether they should be moved to Class B or to Class A for the taxable year ended September 30, [redacted].

Similarly, with respect to category (2) described above, in the absence of any information as to when those items first appeared in [redacted] LIFO inventory, we cannot determine whether those items should have been included in Class B or in Class A for the taxable year ended September 30, [redacted].

With respect to category (3) described above, we agree that those items should have been included in Class A for the taxable year ended September 30, [redacted]. Under the structure set forth in the closing agreement, Class A is the residual class, and once an item enters Class A, it remains there until it is no longer part of the LIFO inventory pool.

With respect to category (4) described above, we agree that that item cannot properly be included in Class C for the taxable year ended September 30, [redacted]. Indeed, if that item was properly included in Class C for the taxable year ended September 30, [redacted], then the only class in which it could properly be included in the taxable year ended September 30, [redacted] is Class A.

Finally, with respect to category (5) described above, in the absence of any information as to when that item first appeared in [redacted] LIFO inventory, we cannot determine whether it should have been included in Class B or in Class A for the taxable year ended September 30, [redacted].

CONCLUSIONS AND RECOMMENDATIONS

For the reasons set forth above, it is our opinion that (1) [redacted] is permitted to include its [redacted] and [redacted] in the same dollar-value LIFO inventory pool; (2) credit/rebill

[redacted] should be excluded from [redacted] dollar-value LIFO pools unless [redacted] obtained the Service's consent to include them; and (3) at least some of your proposed reclassifications of items are appropriate under the terms of the closing agreement.

We recommend that you review the Service's files, and conduct whatever other information-gathering activities you deem appropriate under the circumstances, in order to definitively determine (1) whether [redacted] ever obtained the Service's permission to change its method of accounting to include credit/rebill [redacted] in its dollar-value LIFO pools and (2) the exact dates on which the items in question in issue 3, above, first entered [redacted] dollar-value LIFO inventory. Once that information has been obtained, we recommend that you revise your computations of the amount of the adjustment in accordance with your findings and the legal opinions set forth in this memorandum.

If you have any questions regarding any of the matters discussed in this memorandum, please feel free to call [redacted] of this office at [redacted].